

Internal Revenue Service

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Date:
May 04, 2010

Legend:

X =

A =

B =

C =

State =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Trust 1 =

Trust 2 =

LP =

Dear _____ :

This responds to a letter dated _____, and subsequent correspondence, submitted on behalf of X, requesting a ruling under § 1362(f) of the Internal Revenue Code.

FACTS

According to the information submitted, X incorporated on Date 1 under the laws of State. X elected to be treated as an S corporation effective Date 1. On Date 2, stock in X was transferred to Trust 1. Trust 1 was intended to be a Qualified Subchapter S Trust (QSST), however the beneficiary of Trust 1, A, did not file a timely QSST election, which resulted in a termination of X's S corporation status.

Stock in X was also transferred Trust 2 on Date 3. Trust 2 was a grantor trust treated as owned by A.

On Date 4, A died. Following A's death, the shares of X held by Trust 1 were treated as transferred to Trust 2 and Trust 2 was intended to be treated as an Electing Small Business Trust (ESBT) as of Date 5, but Trust 2 did not file a timely ESBT election.

On Date 6, A, B, and C formed LP to hold shares of X stock. A, B, and C reported their share of the income, deductions and credits of X as if they were the direct shareholders of X and LP did not exist.

X represents that its S corporation election termination was inadvertent and was not motivated by tax avoidance or retroactive tax planning. X and its shareholders agree to make any adjustments required by the Secretary consistent with the treatment of X as an S corporation.

LAW AND ANALYSIS

Section 1361(a)(1) defines an "S corporation" as a small business corporation for which an election under § 1362(a) is in effect for the taxable year.

Section 1361(b)(1)(B) provides that a small business corporation cannot have as a shareholder a person (other than an estate, a trust described in § 1361(c)(2), or an organization described in § 1361(c)(6)) who is not an individual.

Section 1361(c)(2)(A)(i) provides that, for purposes of § 1361(b)(1)(B), a trust all of which is treated (under subpart E of part I of subchapter J of chapter 1) as owned by an individual who is a citizen or resident of the United States may be a shareholder.

Section 1361(d)(1) provides that a QSST whose beneficiary makes an election under § 1361(d)(2) will be treated as a trust described in § 1361(c)(2)(A)(i) and the beneficiary of such trust shall be treated as the owner (for purposes of § 678(a)) of that portion of the QSST which consists of S corporation stock to which an election under § 1361(d)(2) applies. Section 1361(d)(2) provides that a beneficiary of a QSST may elect to have § 1361(d) apply. Under § 1361(d)(2)(D), this election will be effective up to 15 days and 2 months before the date of the election.

Section 1361(d)(3) defines a QSST as a trust (A) the terms of which require that (i) during the life of the current income beneficiary, there shall be only one income beneficiary of the trust; (ii) any corpus distributed during the life of the current income beneficiary may be distributed only to such beneficiary; (iii) the income interest of the current beneficiary in the trust shall terminate on the earlier of the beneficiary's death or the termination of the trust; and (iv) upon the termination of the trust during the life of the current income beneficiary, the trust shall distribute all of its assets to that beneficiary; and (B) all of the income (within the meaning of § 643(b)) of which is distributed (or required to be distributed) currently to one individual who is a citizen or resident of the United States.

Section 1361(c)(2)(A)(v) states that an ESBT is a permissible shareholder of an S Corporation.

Section 1361(e)(1) defines an ESBT, in part, as a trust if such trust does not have (1) a beneficiary any person other than (I) an individual, (II) an estate, (III) an organization described in paragraph (2), (3), (4), or (5) of section 170(c), or (IV) an organization described in section 170(c)(1) which holds a contingent interest in such trust and is not a potential current beneficiary; (2) no interest in such trust was acquired by purchase, and; (3) an election under this subsection applies to such trust.

Section 1361(c)(2)(A)(ii) and § 1.1361-1(h)(1)(ii) provide that, for purposes of § 1361(b)(1)(B), a trust that is described in § 1361(c)(2)(A)(i) immediately before the death of the deemed owner and that continues in existence after such death is a permitted shareholder, but only for the two-year period beginning on the day of the deemed owner's death. Section 1.1361-1(h)(3)(i)(B) provides that if stock is held by a trust described in § 1.1361-1(h)(1)(ii), the estate of the deemed owner is generally treated as the shareholder as of the day of the deemed owner's death.

Section 1362(d)(2)(A) provides that an election under § 1362(a) shall be terminated whenever (at any time on or after the first day of the taxable year for which the corporation is an S corporation) the corporation ceases to be a small business corporation. The termination is effective on and after the day of cessation. § 1362(d)(2)(B).

Section 1362(f) provides that if (1) an election under § 1362(a) by any corporation (A) was not effective for the taxable year for which made (determined without regard to § 1362(b)(2)) by reason of a failure to meet the requirements of § 1361(b) or to obtain shareholder consent, or (B) was terminated under § 1362(d)(2) or (3), (2) the Secretary determines that the circumstances resulting in such ineffectiveness or termination were inadvertent, (3) no later than a reasonable period of time after discovery of the circumstances resulting in the termination, steps were taken - (A) so that the corporation is a small business corporation, or (B) to acquire the required shareholder consents, and (4) the corporation, and each person who was a shareholder of the corporation at any time during the period specified pursuant to this subsection, agrees to make such adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary with respect to such period, then, notwithstanding the circumstances resulting in such termination, such corporation shall be treated as an S corporation during the period specified by the Secretary.

CONCLUSION

Based solely on the facts submitted and the representations made, we conclude X's S election terminated on Date 2 as a result of the transfer of X shares to Trust 1 and that the termination was inadvertent within the meaning of § 1362(f).

We further hold that, pursuant to § 1362(f), X will be treated as continuing to be an S corporation from Date 2 and thereafter, assuming X's S election is valid and not otherwise terminated under § 1362(d). Trust 1 will be treated as a QSST as of Date 2 until A's death. Following A's death Trust 1 will be treated as a trust described in § 1361(c)(2)(A)(ii). Trust 2 will be treated as an ESBT as of Date 5 and thereafter.

This ruling is contingent upon, within 60 days from the date of this letter, B, as the administrator of A's estate, filing an election to treat Trust 1 as a QSST, effective Date 2, and the trustee of Trust 2 electing to treat Trust 2 as an ESBT, effective Date 5, with the appropriate service center. A copy of this letter should be attached to the QSST and ESBT elections. If these conditions are not met, then this ruling is null and void.

The shareholders of X must include in their income their pro rata share of separately stated and nonseparately computed items of X as provided in § 1366, make any adjustments to basis as provided in § 1367, and take into account any distributions made by X as provided in § 1368. This ruling is contingent upon X and each of its shareholders filing any amended returns that are necessary to properly reflect the reporting of X's items of S corporation income.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this

requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

Except as specifically set forth above, no opinion is expressed or implied concerning the federal tax consequences of the above-described facts under any other provision of the Code, including whether X was otherwise a valid S corporation, whether Trust 1 was otherwise a valid QSST, and whether Trust 2 was otherwise a valid ESBT.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Pursuant to the power of attorney on file with this office, a copy of this letter will be sent to X's authorized representative.

Sincerely,

/s/

Faith P. Colson
Senior Counsel, Branch 1
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

Enclosures:

Copy of this letter

Copy for § 6110 purposes

cc: